

Message Text

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TO AMEMBASSY MANILA IMMEDIATE
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MANILA FOR USADB

E.O. 11652: N/A

TAGS: ADB, EGEN

SUBJECT: ADB, LIKELY TO CUT LENDING RATE

1. SUMMARY: IBRD HAS JUST ANNOUNCED REDUCTION IN ITS
LENDING RATE TO 8.0 PERCENT FOR THE THIRD QUARTER FROM 8.2
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PERCENT IN THE SECOND QUARTER. ADB, WHICH SET ITS RATE FOR
1977 IN FEBRUARY AT 8.7 PERCENT, IS REPORTEDLY UNDER STRONG
PRESSURE FROM BORROWING MEMBER COUNTRIES TO REMAIN 'COMPE-
TITIVE' BY FOLLOWING IBRD RATE CUT. SUCH ACTION WOULD
REDUCE ADB LENDING RATE TO ALMOST THE COST OF ITS FUNDS
LAST YEAR AND FURTHER INCREASE SUBSIDY ELEMENT IN ADB LEND-
ING RATE. U.S. CONSIDERS THAT FINANCIALLY UNSOUND AND IR-
RESPONSIBLE BANK POLICY. USADB REQUESTED TO ADVISE ADB
MANAGEMENT AND OTHER DIRECTORS OF U.S. POSITION AND SEEK TO
PREVENT ANY CUT IN ADB LENDING RATE AT THIS TIME. OTHER

ACTION ADDRESSEES REQUESTED TO CONVEY U.S. VIEWS TO APPROPRIATE GOVERNMENT OFFICIALS AND SEEK THEIR SUPPORT IN ADB BOARD. END SUMMARY.

2. ON JUNE 30 IBRD ANNOUNCED REDUCTION IN THE INTEREST RATE CHARGED ON LOANS FROM 8.2 PERCENT PREVAILING IN THE SECOND QUARTER TO 8.0 PERCENT FOR LOANS TO BE APPROVED IN THE THIRD QUARTER. THIS REDUCTION FOLLOWS FROM APPLICATION OF AUTOMATIC LENDING RATE FORMULA ESTABLISHED MID-1976.

EACH QUARTER IBRD CALCULATES WEIGHTED AVERAGE COST OF FUNDS DURING THE PREVIOUS FOUR QUARTERS AND ADDS 0.5 PERCENT (50 BASIS POINTS) TO COVER ADMINISTRATIVE COSTS. U.S. BELIEVES ANNOUNCED RATE CUT IS TEMPORARY AND THAT END OF SEPTEMBER APPLICATION OF FORMULA WILL RAISE IBRD LENDING RATE AGAIN IN VIEW OF FIRING INTEREST RATES IN U.S. WHERE IBRD PLANS TO MAKE HEAVY BORROWINGS IN THIRD QUARTER. IDB CALCULATES ITS RATE ONLY TWICE EACH YEAR UNDER SIMILAR FORMULA, ALSO ANNOUNCED REDUCTION IN LENDING RATE FOR SECOND HALF 1977 ALSO TO EIGHT PERCENT FROM CURRENT 8.35 PERCENT.

3. PURPOSE OF LENDING RATE FORMULAS ADOPTED BY IBRD AND LIMITED OFFICIAL USE
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REGIONAL BANKS AT U.S. INSISTENCE IS TO AUTOMATICALLY ADJUST RATES TO CHANGES IN BANKS' COST OF FUNDS IN ORDER TO ELIMINATE POSSIBILITIES OF SUBSIDIZING LOANS. ADB, WHICH ADOPTED A LENDING RATE FORMULA IN FEBRUARY THIS YEAR DESPITE U.S. MISGIVINGS, REQUIRES RATE BE SET FOR THE YEAR EACH JANUARY. REASON FOR THIS IS THAT ADB STILL A COMPARATIVELY YOUNG INSTITUTION WITH MUCH MORE INFREQUENT BORROWING; THIS MAKES IT DIFFICULT TO COMPUTE MEANINGFUL AVERAGES OF BORROWING COSTS FOR LESS THAN A YEAR. FOR EXAMPLE, ONLY ONE SMALL BOND ISSUE HAS BEEN FLOATED THUS FAR IN 1977; THEREFORE BULK OF 1977 LENDING WILL BE FUNDED OUT OF 1976 BORROWINGS AND WILL NEED TO COVER THIS COST AS WELL AS COSTS OF ADMINISTRATION TO EXTENT POSSIBLE. IN THE PAST, ADB COSTS HAVE BEEN ABOVE COMPARABLE IBRD ISSUES
(IN 1976 DIFFERENTIAL IN WEIGHTED AVERAGE COST WAS 30 BASIS POINTS).

4. CURRENT RATE OF 8.70 PERCENT ESTABLISHED IN FEBRUARY IS ONLY 27 BASIS POINTS ABOVE NORMALIZED AVERAGE BORROWING COSTS IN 1976 OF 8.43 PERCENT AND THEREFORE ALREADY CONTAINS A CONSIDERABLE SUBSIDY OF ADMINISTRATIVE COSTS. THAT RATE WAS ADOPTED FOR 'COMPETITIVE' REASONS SO AS TO MAINTAIN PREVIOUS 20 BASIS POINT SPREAD OVER IBRD RATE OF 8.5 PERCENT IN FIRST QUARTER. THAT SPREAD WILL NOW WIDEN TO 70 BASIS POINTS WHICH BORROWING MEMBERS MAY

CONSIDER UNACCEPTABLE.

5. USADB SHOULD DRAW ON THE FOLLOWING POINTS:

(A) U.S. RECOGNIZES THAT INCREASED SPREAD BETWEEN ADB/IBRD LENDING RATE TO 70 BASIS POINTS WILL MAKE ADB SOMEWHAT LESS COMPETITIVE, BUT U.S. BELIEVES IT WILL NOT SIGNIFICANTLY AFFECT BANK'S ABILITY TO COMMIT PROJECTED LOANS IN THE REMAINDER OF THIS YEAR.

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(B) DURING THE REMAINDER OF 1977, ADB IS EXPECTED TO APPROVE THREE-QUARTERS OF 655 MILLION DOL LOANS BUDGETED FOR THIS YEAR. THEREFORE, THE LENDING RATE APPLIED TO THOSE LOANS WILL HAVE AN IMPORTANT IMPACT ON ADB'S EARNINGS PERFORMANCE FOR MANY YEARS.

(C) MANAGEMENT AND BORROWING MEMBER COUNTRIES SHOULD REALIZE THAT INVESTMENT BANKERS AND PRIVATE FINANCIAL COMMUNITY PURCHASING ADB SECURITIES WILL QUICKLY LEARN THAT IF THE ADB REDUCED ITS RATE, IT WILL BE LENDING VIRTUALLY AT COST. THIS IS FINANCIALLY UNSUSTAINABLE. IF INVESTORS ALTERED THEIR CURRENT VIEWS REGARDING ADB'S SOUND AND RESPONSIBLE BANKING POLICIES, IT WOULD RESULT IN HIGHER BORROWING COSTS FOR BANK AND ITS MEMBERS, THEREBY ULTIMATELY DEFEATING THE OBJECTIVE OF THE PROPOSED LENDING RATE REDUCTION.

(D) IN ADDITION, ADB COULD LOSE RESPECT OF MEMBERS OF THE U.S. CONGRESS FOR ITS HERETOFORE PRUDENT MANAGEMENT.

(E) FOR THESE REASONS, U.S. CONSIDERS ANY REDUCTION IN ADB LENDING RATE AT THIS TIME IN VIEW OF PROBABLE TEMPORARY REDUCTION IN IBRD LENDING RATE AS BEING CONTRARY TO SOUND BANK POLICY AND, THEREFORE, UNACCEPTABLE.

6. OTHER ADDRESSEE POSTS SHOULD DRAW ON THE FOLLOWING POINTS IN APPROACHING APPROPRIATE OFFICIAL OF HOST GOVT:

(A) THE U.S. BELIEVES THAT THE ASIAN DEVELOPMENT BANK IS ABOUT TO CIRCULATE A STAFF PAPER WHICH AT THE URGING OF BORROWING MEMBERS RECOMMENDS THAT THE BANK REDUCE ITS LENDING RATE BY 0.2 PERCENT OR PERHAPS EVEN MORE FROM THE CURRENT RATE OF 8.70 PERCENT. SUCH A STEP WOULD FOLLOW
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THE IBRD'S RECENT DECISION TO REDUCE ITS LENDING RATE BY

20 BASIS POINTS TO 8.0 PERCENT.

(B) WE ARE DEEPLY CONCERNED AT THE PROSPECT OF SUCH A REDUCTION IN THE ADB'S RATE. U.S. RECOGNIZES THAT BANK DECISION TO REFRAIN FROM THIS STEP WOULD INCREASE DIFFERENTIAL BETWEEN IBRD AND ADB LOAN RATES FROM CURRENT 50 BASIS POINTS AND THEREBY WILL MAKE ADB SOMEWHAT LESS COMPETITIVE. HOWEVER, WE STRONGLY BELIEVE THAT THIS SPREAD WILL NOT SIGNIFICANTLY AFFECT THE BANK'S ABILITY TO COMMIT PROJECTED LOANS IN THE REMAINDER OF THIS YEAR. A REDUCTION, HOWEVER, WOULD WORK AGAINST THE BANK'S LONGER TERM INTERESTS IN MAINTAINING MARKET

CONFIDENCE AND THE SOUNDNESS OF ITS OWN FINANCES.

(C) THIS IS SO BECAUSE THE BANK'S CURRENT LENDING RATE OF 8.70 PERCENT DOES NOT COVER ITS ACTUAL COSTS OF LENDING, WHICH WAS MOST RECENTLY COMPUTED AT 8.43 PERCENT FOR AVERAGE BORROWINGS PLUS AN ESTIMATED 65 BASIS POINTS FOR ADMINISTRATIVE COSTS. IN EFFECT, THE BANK ALREADY IS SUBSIDIZING ITS ADMINISTRATIVE COSTS; THIS IS A PRACTICE WHICH THE IBRD AND IDA ARE NOT NOW FOLLOWING AT U.S. INSISTENCE. TO REDUCE THE LENDING RATE WOULD ONLY INCREASE THE ADB'S SUBSIDY. WE THINK THERE ARE BETTER USES FOR THE BANK'S CAPITAL.

(D) DURING THE REMAINDER OF 1977, THE ADB WILL APPROVE THREE-QUARTERS OF THE \$655 MILLION IN LOANS BUDGETED FOR THIS YEAR. THEREFORE THE LENDING RATE APPLIED TO THESE PROSPECTIVE LOANS WILL HAVE AN IMPORTANT IMPACT ON THE ADB'S EARNING PERFORMANCE FOR MANY YEARS. IN CONTRAST TO THE IBRD, THE ADB IS NOT EXPECTED TO BORROW HEAVILY IN 1977 AND WILL FINANCE THE BULK OF THIS YEAR'S LENDING PROGRAMS OUT OF FUNDS BORROWED IN 1976 AT THE 8.43 PERCENT AVERAGE COST. THE 1976 RATE, WE BELIEVE, LIMITED OFFICIAL USE
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CONTINUES TO REMAIN THE MOST RELEVANT COST IN NEW LOANS.

(E) A REDUCTION BY THE IBRD IN ITS LENDING RATE THEREFORE DOES NOT NECESSARILY CALL FOR SIMILAR ACTION BY THE ADB. THE TWO INSTITUTIONS ARE FOLLOWING DIFFERENT BORROWING PATTERNS IN 1977 AND HAVE DIFFERENT LENDING RATE FORMULAS. THE ADB'S BORROWING COSTS GENERALLY ARE HIGHER THAN THE IBRD, REFLECTING THE FORMER'S RELATIVE YOUTH AND NEED TO CONTINUE TO IMPROVE ITS MARKET STANDING.

(F) IN ORDER TO MAINTAIN THE ADB'S FAVORABLE RECORD IN THE MARKET, IT IS IMPORTANT THAT THE BANK LEND AT RATES WHICH EXCEED ITS BORROWING COSTS AND COVER AS MUCH OF THE

ADMINISTRATIVE COSTS AS POSSIBLE. MANAGEMENT AND MEMBER COUNTRIES MUST REALIZE THAT INVESTMENT BANKERS AND PRIVATE FINANCIAL COMMUNITIES PURCHASING ADB SECURITIES WILL QUICKLY LEARN THAT BANK IS LENDING VIRTUALLY AT COST IF IT REDUCES ITS RATE. THIS AS FINANCIALLY UNSUSTAINABLE. IF INVESTORS ALTERED THEIR CURRENT VIEWS REGARDING ADB'S-- SOUND AND RESPONSIBLE BANKING POLICIES, IT WOULD RESULT IN HIGHER BORROWING COSTS FOR BANK AND ITS MEMBERS. THIS ULTIMATELY WOULD DEFEAT THE OBJECTIVE OF THE PROPOSED LENDING RATE REDUCTION.

(G) IN ADDITION, ADB COULD LOSE RESPECT OF MEMBERS

OF THE U.S. CONGRESS FOR ITS PRUDENT MANAGEMENT. THIS WOULD NOT BE HELPFUL IN LEGISLATIVE CONSIDERATION OF FUTURE FUNDING REQUESTS FOR THE BANK.

(H) FINALLY, WE EXPECT THAT THE IBRD'S DECISION TO LIMITED OFFICIAL USE LIMITED OFFICIAL USE

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REDUCE ITS RATE MAY BE TEMPORARY. FIRMING INTEREST RATES IN MARKETS WHICH THE IBRD IS LIKELY TO TAP IN REMAINDER OF YEAR COULD WELL REQUIRE AN INCREASE IN LENDING RATE

IN THE FOURTH QUARTER.

(I) FOR THESE REASONS, U.S. CONSIDERS ANY REDUCTION IN ADB LENDING RATE AT THIS TIME TO BE CONTRARY TO SOUND BANK POLICY AND THEREFORE UNACCEPTABLE.

7. AS FALLBACK POSITION, IF U.S. IS UNABLE TO MUSTER SUPPORT FOR MAINTAINING CURRENT RATE,

'SADB SHOULD URGE THAT BANK REVIEW ITS LENDING RATE DECISION AFTER THE IBRD ANNOUNCES ITS RATE FOR THE FOURTH QUARTER. USADB SHOULD ALSO URGE THAT ADB RAISE ITS COMMITMENT FEE (ON UNDISBURSED LOANS) FROM THE CURRENT 45 BASIS POINTS TO AT LEAST IBRD LEVEL OF 75 POINTS AND PREFERABLY TO IDB LEVEL OF 1 1/4 PERCENT. THIS WOULD (A) HELP CUSHION ADVERSE IMPACT ON BANK'S EARNINGS OF INCREASING THE SUBSIDY ELEMENT IN ADB LENDING RATE, AND (B) CREATE A MUCH STRONGER INDUCEMENT FOR BORROWERS TO PROMPTLY DRAW DOWN THEIR LOANS. U.S. BELIEVES THAT UNDULY LOW COMMITMENT FEE IS AN IMPORTANT REASON WHY LOAN DISBURSEMENT IS LAGGING. THIS NOT ONLY HAS ADVERSE IMPACT ON ADB'S EARNINGS BUT MORE IMPORTANTLY DELAYS REALIZATION OF DEVELOPMENT BENEFITS IN BORROWING MEMBER COUNTRIES WHICH ALL MEMBERS ARE SEEKING TO FOSTER. ADB'S FIRST QUARTER FINANCIAL STATEMENT INDICATES THAT LOAN DISBURSEMENTS OF ONLY \$57 MILLION WERE

12 PERCENT LOWER THAN FIRST QUARTER 1976 DESPITE 30
PERCENT HIGHER LEVEL OF OUTSTANDING LOANS.

8. ACTION REQUESTED:

(A) FOR USADB: PRESENT US VIEWS IN PARA 5 AND, AS
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APPROPRIATE, PARA 6 ADB MANAGEMENT AND SEEK TO
FORESTALL ANY CUT IN BANK'S LENDING RATE AT THIS TIME.
SUPPORT SHOULD ALSO BE SOUGHT FROM OTHER DIRECTORS. IF
IN YOUR JUDGMENT A REDUCTION LOOKS INEVITABLE, DESPITE
OUR EFFORTS, USADB SHOULD FALL BACK TO POSITION IN PARA 7.

(B) OTHER ACTION ADDRESSEES: PRESENT U.S. POSITION

ALONG LINES OF PARA 6 TO APPROPRIATE OFFICIALS CONCERNED
WITH ADB POLICY, SEEK THEIR SUPPORT AND REQUEST THAT THEY
INSTRUCT THEIR EXECUTIVE DIRECTOR ACCORDINGLY. NO
MENTION OF FALLBACK IN PARA 7 SHOULD BE MADE AT THIS
POINT.

(C) ALL ADDRESSEES SHOULD REPORT RESULT OF THEIR
DEMARCHE, INCLUDING ANY SUGGESTIONS FROM OFFICIALS ON HOW
BEST TO MOBILIZE JOINT EFFORTS TO PREVENT POSSIBLE ADB
RATE CUT. VANCE

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